

# Contents

Preface viii  
Acknowledgements xii  
Authors xiii  
Digital Support Resources xiv

## PART I

### Framework 1

#### **1 A framework for business analysis and valuation using financial statements 2**

**The role of financial reporting in capital markets 2**

**From business activities to financial statements 4**

**Influences of the accounting system on information quality 5**

Feature 1: Accrual accounting 5

Feature 2: Accounting conventions and standards 7

Feature 3: Managers' reporting strategy 8

Feature 4: Auditing, legal liability, and public enforcement 9

**Alternative forms of communication with investors 10**

Analyst meetings 11

Voluntary disclosure 12

**From financial statements to business analysis 12**

Analysis step 1: Business strategy analysis 14

Analysis step 2: Accounting analysis 14

Analysis step 3: Financial analysis 15

Analysis step 4: Prospective analysis 15

**Public versus private corporations 15**

**Summary 16**

**Core concepts 16**

**Questions, exercises, and problems 18**

**Problem 1 The Neuer Markt 18**

**Problem 2 Fair value accounting for financial instruments 20**

**Notes 21**

**Appendix: Defining Europe 23**

**CASE The role of capital market intermediaries in the dot-com crash of 2000 25**

## PART II

### **Business analysis and valuation tools 45**

#### **2 Strategy analysis 46**

**Industry analysis 46**

Degree of actual and potential competition 46

Bargaining power in input and output markets 50

**Applying industry analysis: The european airline industry 51**

Competition in the european airline industry 51

The power of suppliers and buyers 52

Limitations of industry analysis 53

**Competitive strategy analysis 53**

Sources of competitive advantage 53

Achieving and sustaining competitive advantage 55

Applying competitive strategy analysis 56

**Corporate strategy analysis 57**

Sources of value creation at the corporate level 57

Applying corporate strategy analysis 59

**Summary 60**

**Core concepts 61**

**Questions, exercises, and problems 61**

**Problem 1 The European airline industry 62**

**Notes 64**

**CASE Akris: Competition in the high-end fashion industry 65**

#### **3 Accounting analysis: The basics 78**

**Factors influencing accounting quality 78**

Noise from accounting rules 78

Forecast errors 79

Managers' accounting choices 79

**Steps in accounting analysis 80**

Step 1: Identify key accounting policies 81

Step 2: Assess accounting flexibility 81

Step 3: Evaluate accounting strategy 82

Step 4: Evaluate the quality of disclosure 83

Step 5: Identify potential red flags 84  
 Step 6: Recast financial statements and undo accounting distortions 85

### **Recasting financial statements** 86

Some complications 86  
 Categories of financial statement items 87

### **Accounting analysis pitfalls** 95

Conservative accounting is not "good" accounting 95  
 Not all unusual accounting is questionable 96  
 Common accounting standards are not the same as common accounting practices 96

### **Value of accounting data and accounting analysis** 96

#### **Summary** 97

#### **Core concepts** 97

#### **Questions, exercises, and problems** 98

#### **Problem 1 Key accounting policies** 99

#### **Problem 2 Fashion retailers' key accounting policies** 99

#### **Problem 3 Euro Disney and the first five steps of accounting analysis** 100

#### **Notes** 102

#### **Appendix A: First-time adoption of IFRS Standards** 104

#### **Appendix B: Recasting financial statements into standardized templates** 105

#### **CASE Toshiba: Accounting fraud** 111

## **4 Accounting analysis: Accounting adjustments** 118

### **Recognition of assets** 118

Who owns or controls resources? 119  
 Can economic benefits be measured with reasonable certainty? 120  
 Have fair values of assets declined below book value? 120  
 Are fair value estimates accurate? 121

### **Asset distortions** 122

### **Recognition of liabilities** 140

Has an obligation been incurred? 140  
 Can the obligation be measured? 140

### **Liability distortions** 141

### **Equity distortions** 147

Contingent claims 147

#### **Summary** 148

#### **Core concepts** 149

#### **Questions, exercises, and problems** 150

#### **Problem 1 Impairment of non-current assets** 153

#### **Problem 2 Audi, BMW, and Skoda's research and development** 153

#### **Problem 3 H&M and Inditex's non-current assets** 155

#### **Notes** 156

#### **CASE Accounting for the iPhone Upgrade Program (A)** 158

## **5 Financial analysis** 174

### **Ratio analysis** 174

Measuring overall profitability 178  
 Decomposing profitability: Traditional approach 179  
 Decomposing profitability: Alternative approach 180  
 Assessing operating management: Decomposing net profit margins 184  
 Evaluating investment management: Decomposing asset turnover 188  
 Evaluating financial management: Financial leverage 191  
 Putting it all together: Assessing sustainable growth rate 194  
 Historical patterns of ratios for European firms 197

### **Cash flow analysis** 197

Cash flow and funds flow statements 197  
 Analyzing cash flow information 199  
 Analysis of Hennes & Mauritz's and Inditex's cash flow 202

#### **Summary** 203

#### **Core concepts** 203

#### **Questions, exercises, and problems** 205

#### **Problem 1 ROE decomposition** 205

#### **Problem 2 Ratios of three fashion retailers** 208

#### **Problem 3 The Fiat Group in 2008** 211

#### **Problem 4 Ahold versus Delhaize** 213

#### **Notes** 215

#### **Appendix: Hennes & Mauritz AB financial statements** 216

#### **CASE Carrefour S.A.** 221

## **6 Prospective analysis: Forecasting** 232

### **The overall structure of the forecast** 232

A Practical Framework for Forecasting 233  
 Information for forecasting 234

### **Performance behavior: A starting point** 235

Revenue growth behavior 236  
 Earnings behavior 236  
 Returns on equity behavior 237  
 The behavior of components of ROE 238

### **Forecasting assumptions** 239

Background: Macroeconomic and industry growth 239  
 Revenue growth 240  
 NOPAT margins 243  
 Working capital to revenue 245  
 Non-current assets to revenue 246  
 Non-operating investments 247

Capital structure 247

**From assumptions to forecasts** 247

Cash flow forecasts 250

**Sensitivity analysis** 250

Seasonality and interim forecasts 251

**Summary** 252

**Core concepts** 252

**Questions, exercises, and problems** 253

**Problem 1 Predicting Tesco's 2017/2018 earnings** 254

**Notes** 257

**Appendix: The behavior of components of ROE** 257

**CASE Forecasting earnings and earnings growth in the European oil and gas industry** 260

## **7 Prospective analysis: Valuation theory and concepts** 274

**Defining value for shareholders** 275

**The discounted cash flow model** 276

**The discounted abnormal profit model** 278

Accounting methods and discounted abnormal profit 279

**The discounted abnormal profit growth model** 280

**Valuation using price multiples** 285

Main issues with multiple-based valuation 285

Determinants of value-to-book and value-earnings multiples 286

**Shortcut forms of profit-based valuation** 289

Abnormal profit (growth) simplification 289

ROE and growth simplifications 291

**Comparing valuation methods** 291

Focus on different issues 292

Differences in required structure 292

Differences in terminal value implications 292

**Summary** 294

**Core Concepts** 294

**Summary of notations used in this chapter** 295

**Questions, exercises, and problems** 296

**Problem 1 Estimating Hugo Boss's equity value** 297

**Problem 2 Estimating Adidas's equity value** 298

**Notes** 299

**Appendix A: Asset valuation methodologies** 300

**Appendix B: Reconciling the discounted dividends, discounted abnormal profit, and discounted abnormal profit growth models** 301

**CASE Valuation Multiples in Fast Fashion** 303

## **8 Prospective analysis: Valuation implementation** 312

**Computing a discount rate** 312

Estimating the cost of equity 313

Estimating the required return on net operating assets 318

Estimating the weighted average cost of capital 318

Detailed forecasts of performance 322

Making performance forecasts for valuing H&M 322

**Terminal Values** 324

Terminal values with the competitive equilibrium assumption 326

Competitive equilibrium assumption only on incremental revenue 326

Terminal value with persistent abnormal performance and growth 326

Terminal value based on a price multiple 327

Selecting the terminal year 328

Estimates of Hennes & Mauritz's terminal value 328

**Computing Estimated Values** 329

From asset values to equity values 331

Asset valuation versus equity valuation 333

Value estimates versus market values 334

Sensitivity analysis 334

**Some practical issues in valuation** 335

Dealing with accounting distortions 335

Dealing with negative book values 335

Dealing with excess cash flow 336

**Summary** 336

**Core concepts** 337

**Questions, exercises, and problems** 338

**Problem 1 Hugo Boss's and Adidas's terminal values** 339

**Problem 2 Anheuser-Busch InBev S.A.** 339

**Notes** 340

**CASE Ferrari: The 2015 Initial Public Offering** 341

## **PART III**

### **Business analysis and valuation applications** 357

#### **9 Equity security analysis** 358

**Investor objectives and investment vehicles** 358

**Equity security analysis and market efficiency** 360

Market efficiency and the role of financial statement analysis 360

Market efficiency and managers' financial reporting strategies 361

Evidence of market efficiency 361

### **Approaches to fund management and securities analysis** 361

Active versus passive management 362

Quantitative versus traditional fundamental analysis 362

Formal versus informal valuation 362

### **The process of a comprehensive security analysis** 362

Selection of candidates for analysis 363

Inferring market expectations 363

Developing the analyst's expectations 366

The final product of security analysis 366

### **Performance of security analysts and fund managers** 367

Performance of security analysts 367

Performance of fund managers 368

**Summary** 369

**Core concepts** 369

**Questions** 370

**Notes** 371

**CASE Valuation at Novartis** 373

## **10 Credit analysis and distress prediction** 386

**Why do firms use debt financing?** 386

**The market for credit** 388

Commercial banks 389

Non-bank financial institutions 389

Public debt markets 389

Sellers who provide financing 390

**Country differences in debt financing** 390

Country factors and credit types 390

Country factors and the optimal mix of debt and equity 391

**The credit analysis process in private debt markets** 392

Step 1: Consider the nature and purpose of the loan 393

Step 2: Consider the type of loan and available security 393

Step 3: Conduct a financial analysis of the potential borrower 395

Step 4: Assemble the detailed loan structure, including loan covenants 396

**Financial statement analysis and public debt** 398

The meaning of debt ratings 398

Factors that drive debt ratings 399

**Prediction of distress and turnaround** 402

Models for distress prediction 402

Investment opportunities in distressed companies 404

**Credit ratings, default probabilities, and debt valuation** 404

**Summary** 407

**Core concepts** 408

**Questions** 409

**Notes** 410

**CASE Getronics' debt ratings** 411

## **11 Mergers and acquisitions** 417

**Motivation for merger or acquisition** 417

**Acquisition pricing** 420

Analyzing premium offered to target shareholders 420

Analyzing value of the target to the acquirer 421

DuPont's pricing of Danisco 424

**Acquisition financing and form of payment** 424

Effect of form of payment on acquiring shareholders 424

Effect of form of payment on target shareholders 426

DuPont's financing of Danisco 426

**Acquisition outcome** 427

Other potential acquirers 427

Target management entrenchment 428

Antitrust and security issues 429

Analysis of outcome of DuPont's offer for Danisco 429

**Reporting on mergers and acquisitions: Purchase price allocations** 430

Danisco's purchase price allocation 432

**Summary** 441

**Core concepts** 441

**Questions** 442

**Notes** 443

**CASE Glencore/Xstrata: Playing Aida's Triumphal March on Top of the Everest** 445

## **PART IV**

### **Additional cases** 459

**1 Enforcing financial reporting standards: The case of White Pharmaceuticals AG** 460

**2 KarstadtQuelle AG** 468

**3 Tesco: From Troubles to Turnaround** 479

**4 Valuing Europe's fastest growing company: HelloFresh in 2017** 490

**5 Spotify's direct-listing IPO** 499

**6 The Air France–KLM merger** 519

**7 Measuring impairment at Dofasco** 539

**8 The initial public offering of PartyGaming Plc** 558

**9 Two European hotel groups (A): Equity analysis** 568

**10 Two European hotel groups (B): Debt analysis** 577

**11 Fiat Group's first-time adoption of IFRS Standards** 582

**Index** 599